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# Upstream, Overseas, and Underwater: When a Foreign Subsidiary Files Bankruptcy in the United States, Which Legal Standards Control the Treatment of an Upstream Guaranty

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# COMMENTS

## UPSTREAM, OVERSEAS, AND UNDERWATER: WHEN A FOREIGN SUBSIDIARY FILES BANKRUPTCY IN THE UNITED STATES, WHICH LEGAL STANDARDS CONTROL THE TREATMENT OF AN UPSTREAM GUARANTY?

### I. INTRODUCTION

As corporations become multinational entities, with affiliations across the globe, international insolvencies turn from speculation to reality. International insolvencies create special problems for the bankruptcy court administering an international corporation's assets.

This Comment will focus on how a U.S. bankruptcy court's use of U.S. bankruptcy law may impact the foreign creditors of an insolvent entity. Specifically, a U.S. court's valuation of a guaranty may result in decisions that are unfair to foreign creditors and contrary to a foreign country's policies. An additional consideration is whether U.S. courts will recognize a foreign country's laws in an ancillary proceeding, thus frustrating U.S. bankruptcy policy.

Part II of this Comment outlines a hypothetical situation to illustrate the issues and problems of applying different laws in multijurisdictional bankruptcies. Part III discusses general relevant bankruptcy principles that illustrate how U.S. bankruptcy court decisions effectuate or frustrate bankruptcy policies of foreign countries. Specifically, Part III examines the policies of the United States, the United Kingdom, and Canada. Part III also discusses the implications of ancillary proceedings in which bankruptcy courts determine whether to afford comity to foreign jurisdictions. Part IV gives an overview of fraudulent transfer law, insolvency, and guaranty valuation in the United States, the United Kingdom, and Canada. The specific laws and their differences are used in Part V to explore the ramifications of a U.S. bankruptcy court's application of U.S. bankruptcy law when a foreign corporation files for bankruptcy in the United States.

This Comment concludes that, if U.S. bankruptcy courts follow another country's laws, the result may be unfair and

disproportionate when applied to creditors, and unwieldy for adjudication in U.S. bankruptcy courts.

## II. A HYPOTHETICAL CASE OF INTERNATIONAL BANKRUPTCY

This Comment will refer to the following hypothetical bankruptcy case involving an international corporation for illustrative purposes:

Pargen, Inc. ("Pargen"), a U.S. corporation, is a holding corporation<sup>1</sup> of several subsidiaries. Finding it expedient to do genetic testing outside the United States, Pargen established several subsidiaries in different countries.

Eight months ago, Pargen caused two of its foreign subsidiaries to guaranty<sup>2</sup> two separate bank loans that Pargen was obtaining from Genbank, Inc. ("Genbank"), a U.S. bank.<sup>3</sup> This guaran-

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1. A holding corporation is "[a] company that usually confines its activities to owning stock in, and supervising management of, other companies." BLACK'S LAW DICTIONARY 731 (6th ed. 1990). If the holding corporation owns a majority of the shares of the other company, it is referred to as the parent corporation. *Id.* at 1114. The company in which the parent owns stock is called a subsidiary. *Id.* at 1428. The subsidiaries, however, hold the tangible assets and cash flow. A lender would want to attach these assets as collateral against the possibility that the loan may not be repaid.

2. A guaranty is a promise by one entity or person to a lender that it will make payments on another's debt. Raymer McQuiston, *Drafting an Enforceable Guaranty in an International Financing Transaction: A Lender's Perspective*, 10 INT'L TAX & BUS. LAW. 138, 138 (1993). The usual situation is one where the bank (lender) loans money to X (a corporate borrower), but is unwilling to give the loan based on the financial status of X, and thus requires further assurance that the debt will be paid. Therefore, Y corporation (guarantor) promises that if X does not pay, Y will pay X's debt to the bank.

If the borrower defaults on the loan by failing to make payments, the lender can look to the guarantor for payment of the loan. *Id.* If the guarantor refuses to pay, the lender can sue the guarantor and then seize the guarantor's assets, or the lender may be able to attach assets prior to suit if the assets were pledged as collateral. Robert K. Rasmussen, Comment, *Guaranties and Section 548(a)(2) of the Bankruptcy Code*, 52 U. CHI. L. REV. 194, 194 (1985).

A simple example of a guaranty is where the parents are co-makers on a student loan for a child. The lender is unwilling to loan to the student because of the high risk of nonpayment, but is willing to make the loan if the parents are guarantors, since the parents are likely to make the payments if the student does not, and the lender can reach the parents' assets upon judgment.

Thus, if the student defaults on the loan, the lender may sue the parents and obtain satisfaction in the form of a lien. Possible recourse of the creditor may include foreclosing on the parents' home, gaining possession and selling the parents' cars, or garnishing the parents' wages.

3. Problems of obtaining jurisdiction over a foreign lender are beyond the scope of this paper. See Allan L. Gropper, Comment, *The Bankruptcy Code's Approach to Multinational Bankruptcies: Basic Legal Framework*, 628 PRAC. L. INST. 49, 54-62, 71-72 (1992); Jay L. Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law*

ty situation is called an upstream guaranty.<sup>4</sup> Engen, Inc. ("Engen"), based in the United Kingdom, guarantied a one hundred million dollar loan from Genbank to Pargen, and Cangen, Inc. ("Cangen"), based in Canada, similarly guarantied a debt of one hundred million dollars from Genbank to Pargen.

Pargen immediately defaulted on the loan, and never made any payments. Once Pargen defaulted, Genbank had the right to hold the guarantor subsidiary corporations to their guaranties.<sup>5</sup> As expected, three months later, Genbank held the subsidiaries to their guaranties and collected the amounts of the debt owed by Pargen from the subsidiaries. As will be seen, in the United States, the trustee can attempt to "avoid" these transfers.<sup>6</sup>

One month later, both Engen and Cangen filed for bankruptcy under Chapter 11 in the United States.<sup>7</sup> At that point, the bankruptcy trustee<sup>8</sup> filed a motion to avoid the pre-petition

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and Choice of Forum, 65 AM. BANKR. L.J. 457 (1991); see also Mary E. Knecht, *The "Draper of Illusion" of Section 304—What Lurks Beneath: Territoriality in the Judicial Application of Section 304 of the Bankruptcy Code*, 13 U. PA. J. INT'L BUS. 287 (1992).

4. David S. Walls, *Promises to Keep: Intercorporate Guaranties and Fraudulent Transfers in Bankruptcy*, 19 UCC L.J. 219, 228 (1987) (defining an upstream guaranty as one where the subsidiary guaranties the debt of the parent corporation).

5. Rasmussen, *supra* note 2, at 194. The subsidiary must either pay the obligation or the assets of the subsidiary will be sold and used to pay off the lender. This situation can become very complex. In some instances, the parent corporation may require a subsidiary to guaranty the loans of other subsidiary companies of the parent corporation. These cross-guaranties can result in serious financial problems. For example, when one of the subsidiaries goes bankrupt, it may impact all of the parent corporation's holdings.

6. The 1994 Bankruptcy Reform Bill limiting the liability of Non-insider Transferees does not impact this Comment. The code sections referred to in this Comment were not amended. H.R. 5116, 103d Cong., 2d Sess. § 202 (1994).

7. Venue and jurisdiction are assumed for the purposes of this Comment. Venue may be obtained under 11 U.S.C. § 1408(1) where the domicile, residence, principal place of business, or location of the debtor's principal assets in the United States has existed for the majority of the past 180 days. 11 U.S.C. § 1408(1) (1988 & Supp. V 1993). Venue is also proper under 28 U.S.C. § 1408(2) where the debtor's affiliate, general partner, or partnership has a pending bankruptcy. Martin N. Filcs & Michael J. Ireland, Comment, *Bankruptcy and the Problems of Multijurisdictional Workouts*, 29 PRAC. L. INST. 415, 416 (1991).

Jurisdiction may be obtained under 11 U.S.C. § 109 or 28 U.S.C. § 1334(b), (d). 11 U.S.C. § 109 (1988 & Supp. V 1993); 28 U.S.C. § 1334(b), (d) (1988 & Supp. V 1993). A foreign subsidiary may file in the United States if it owns assets in the United States or satisfies other prerequisites contained within the statute. The U.S. court, however, may not be able to obtain personal jurisdiction over foreign creditors. Therefore, if the transfer in question was made to a foreign entity, the court might be unable to order the funds or assets returned. Gropper, *supra* note 3, at 55-57.

8. The motion may be filed by either the trustee, the debtor-in-possession ("DIP"), or a creditor. See Scott F. Norberg, Comment, *Avoidability of Intercorporate Guarantees*

transfers as fraudulent.<sup>9</sup> If the bankruptcy court holds that the transfers were fraudulent, Genbank must return the money it received from Engen and Cangen in connection with the transfers based on the guaranties. The money returned by Genbank would then be distributed among Engen's and Cangen's other creditors in an "equitable" manner.<sup>10</sup>

In a "full" Chapter 11 U.S. bankruptcy, the U.S. bankruptcy court's valuation of the guaranty will impact whether the transfer may be recovered. This determination could result in a holding directly contrary to that of a foreign bankruptcy court.<sup>11</sup>

Additionally, foreign creditors may implement foreign involuntary bankruptcy proceedings against the foreign debtor in the foreign country. If this is done, a foreign representative may come to the U.S. bankruptcy court requesting foreign jurisdiction of the debtor's assets. This ancillary proceeding is governed by 11 U.S.C. § 304. Thus, foreign law may govern whether the transfers are recoverable, and the results could conflict with U.S. bankruptcy law.<sup>12</sup>

### III. GENERAL BANKRUPTCY POLICIES; COMITY BALANCING UNDER ANCILLARY PROCEEDINGS

The policies of bankruptcy systems reflect the priorities and concerns of legislatures. If the bankruptcy system favors creditors, the courts will attempt to protect the creditors' interests in the bankrupt's estate rather than reorganizing the debtor.<sup>13</sup> Conversely, if a bankruptcy system favors debtors it may reflect the

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*Under Sections 548(a)(2) and 544(b) of the Bankruptcy Code*, 64 N.C.L. REV. 1099, 1101 (1986) ("Generally, a creditor or creditor's committee may bring an action to avoid a transfer or obligation when the trustee or debtor in possession has failed to bring the action, thereby not fulfilling the statutory duty to collect the assets of the estate."). The DIP acts as trustee and may move to avoid a fraudulent transfer. 11 U.S.C. § 1107(a) (1988 & Supp. V 1993). Upon application to the court, a creditor may request permission to pursue avoidance of a fraudulent transfer. *See* 11 U.S.C. §§ 544(b), 548(a) (1988 & Supp. V 1993). Hereinafter, the term "trustee" is used to refer to any of these parties.

9. By using the avoidance powers under 11 U.S.C. § 548, the transfer is avoided.

10. BRIAN A. BLUM, *BANKRUPTCY AND DEBTOR/CREDITOR: EXAMPLES AND EXPLANATIONS* 311 (1993).

11. Jay L. Westbrook, *Global Insolvencies in a World of Nation States*, in *CURRENT ISSUES IN INSOLVENCY LAW* 27, 30 (Alison Clarke ed., 1991).

12. *Id.*

13. J.H. DALHUISEN, *DALHUISEN ON INTERNATIONAL INSOLVENCY AND BANKRUPTCY* 2-17 to 2-18, 3-403 to 3-404 (1986).

country's policy that an ongoing entity is more valuable to society because it provides jobs.<sup>14</sup>

### A. Bankruptcy Policies

Bankruptcy policies impact what laws legislatures implement and the courts' application of the laws. All countries develop policies according to their societal norms. The policies countries develop, however, fall into general categories. One bankruptcy scholar states:

All bankruptcy law, no matter when or where devised and enacted, has at least two general objects in view. It aims first to secure an equitable division of the insolvent debtor's property among all his creditors, and second it seeks to prevent conduct on the part of the insolvent debtor detrimental to the interests of his creditors. In other words, bankruptcy law seeks to protect the creditors first from one another and, second from the debtor. A third object, the protection of the honest debtor from his creditors by means of the discharge, is sought to be attained in some of the systems of bankruptcy, but this is by no means the fundamental feature of the law.<sup>15</sup>

In many Commonwealth countries, speed and economy are more important than supervision and accountability.<sup>16</sup> There are also differences in a country's recognition of foreign creditors' rights and a foreign country's laws. Many countries routinely favor local creditors over foreign creditors.<sup>17</sup> One way a court can favor local creditors is by refusing to recognize a foreign jurisdiction's laws.<sup>18</sup> For instance, if a foreign corporation files for bankruptcy in the United States, U.S. bankruptcy courts routinely apply U.S. law.<sup>19</sup>

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14. *Id.*

15. ROBERT L. JORDAN, *BANKRUPTCY* 20 (3d ed. 1993).

16. Westbrook, *supra* note 3, at 476.

17. Westbrook, *supra* note 11, at 28.

18. Some countries have policies that recognize and apply a foreign country's laws while others do not. For example, a U.S. federal district court held that Australian law favors its domestic parties by upholding self-dealing and unfair transactions involving third party insiders. *Interpool, Ltd. v. Certain Freights*, 102 B.R. 373, 379 (D.N.J. 1988).

19. Selinda A. Melnik, *Cross-Border Insolvencies: The United States Perspective—A Primer*, in *INTERNATIONAL BANKRUPTCIES: DEVELOPING PRACTICAL STRATEGIES*, 628 PRAC. L. INST. 225, 230 (1992) (stating "while the Bankruptcy Code is silent on the issue, case law assumes that United States substantive law applies in the involuntary or involuntary case.").

The United Kingdom attempts to balance both the debtor's and creditors' interests with the administration of corporate assets. In the United Kingdom, the policy of facilitating business reorganization is a recent development in its bankruptcy law.<sup>20</sup> U.K. bankruptcy policy objectives include giving the debtor a fresh start and providing the maximum return to creditors.<sup>21</sup> Additionally, U.K. law promotes the continuity of businesses by preserving the value of the corporation.<sup>22</sup>

The U.K. policy of balancing debtor and creditor interests can be compared with the two pervasive policies of the U.S. bankruptcy system. The first goal of the U.S. bankruptcy system is to rehabilitate the debtor.<sup>23</sup> Thus, U.S. bankruptcy policy encourages debtors to make a fresh start.<sup>24</sup> The second and sometimes conflicting goal of the U.S. bankruptcy system is to maximize the value of the estate.<sup>25</sup> The primary policy of rehabilitating the debtor is often reflected in U.S. law. In Chapter 11 bankruptcies, the Bankruptcy Code encourages and facilitates business reorganization.<sup>26</sup> Thus, unlike U.K. policy, orderly administration is not one of the primary purposes of U.S. bankruptcy law.

U.S. and U.K. reorganization plans and policies can be contrasted with Canadian law, which has only recently developed a modern business reorganization policy.<sup>27</sup> With the 1992 legisla-

See Filcs & Ireland, *supra* note 7, at 416 ("The fact that jurisdictions have different substantive laws naturally leads debtors and creditors to prefer the jurisdiction most favorable to the particular party's interests, creating a great deal of controversy when there is more than one jurisdiction that could administer a bankruptcy.").

20. Alison Clarke, *Introduction to CURRENT ISSUES IN INSOLVENCY LAW* at v, viii (Alison Clarke ed., 1991); see also Jeffrey Davis, *Bankruptcy, Banking, Free Trade, and Canada's Refusal to Modernize Its Business Rescue Law*, 26 TEX. INT'L L.J. 253, 259 (1991).

21. Davis, *supra* note 20, at 253. Insolvency Act, 1986, ch. 45, §§ 8-27 (Eng.).

22. Jay L. Westbrook, *A Comparison of Bankruptcy Reorganisation in the U.S. with the Administration Procedure in the U.K.*, 6 INSOLVENCY L. & PRAC. 86, 87 (1990).

23. See H.R. REP. NO. 595, 95th Cong., 2d Sess., at 174, reprinted in 1978 U.S.C.C.A.N. 5963, 6135. See also *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

24. Lauren D. Rosenthal, Note, *Rule 10b-5 and Transnational Bankruptcies: Whose Law Should Apply?*, 61 FORDHAM L. REV. S321, S335 (1993) (stating that Congress has expressly stated a policy favoring rehabilitation of the debtor); see Bankruptcy Reform Act of 1978, 11 U.S.C. § 304 (1988).

25. See *Kothe v. R.C. Taylor Trust*, 280 U.S. 224, 227 (1930).

26. BLUM, *supra* note 10, at 144, 463.

27. E. Bruce Leonard & R. Gordon Marantz, *Practical Strategies in Workouts and Insolvencies in Canada*, in COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES DEALING WITH FOREIGN WORKOUTS AND INSOLVENCIES 1993: PRACTICAL STRATEGIES FOR LENDERS AND INVESTORS, 671 PRAC. L. INST. 291, 296 (1993). Canada's

tion, however, Canada has begun to act more equitably toward debtors. Historically, the purpose behind the Canadian Bankruptcy Act was to allow all creditors to proceed equitably.<sup>28</sup> Still, in Canada, more than in the United Kingdom or the United States, the bankruptcy system favors creditors.<sup>29</sup>

Under the Canadian bankruptcy system, debtors have two options. The Bankruptcy and Insolvency Act<sup>30</sup> (the "BIA") is usually used by smaller businesses.<sup>31</sup> Large corporate debtors, however, may opt to use the Companies' Creditors Arrangement Act (the "Act").<sup>32</sup> Under the BIA, transfers may be avoided for periods up to five years.<sup>33</sup> The Act, however, does not allow for any transfers to be avoided.<sup>34</sup>

Thus, if U.S. courts apply U.S. bankruptcy policies, the results may contradict the policies behind the bankruptcy laws of other countries where the provisions of their laws would yield different results. At issue is whether a foreign debtor should be able to take advantage of U.S. bankruptcy avoidance procedures.<sup>35</sup> According to some bankruptcy scholars:

A question arises as to whether a foreign entity filing for bankruptcy protection in the U.S. may avoid upstream guarantees that would have been enforceable under the laws of the relevant foreign jurisdiction. When a foreign company files for bankruptcy protection in the U.S., it will have access to the avoiding powers provided in the U.S. Bankruptcy Code and would arguably be empowered to avoid upstream guarantees otherwise enforceable under the law of the foreign jurisdiction. However, a U.S. bankruptcy court arguably should abstain from proceed-

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new insolvency legislation became effective November 30, 1992.

28. In *In re Wilanour Resources, Ltd.*, the court noted that the purpose behind the Canadian Bankruptcy Act is "the orderly distribution of the assets of an insolvent debtor ratably among his creditors." *In re Wilanour Resources, Inc.*, 43 C.B.R. 153, 155 (1982) (Can.).

29. *Id.* at 319.

30. R.S.C., ch. B-3, § 1 (1985), amended by ch. 27, 1992 S.C. (Can.).

31. Leonard & Marantz, *supra* note 27, at 304.

32. R.S.C., ch. C-25, § 1 (1985) (Can.). According to Jeffrey Davis, the Act is limited to debtors with "outstanding bonds or debentures issued under a trust deed." Davis, *supra* note 20, at 259 n.38.

33. Bankruptcy Act, R.S.C., ch. B-3, § 91(2) (1985) (Can.).

34. Leonard & Marantz, *supra* note 27, at 304.

35. Joseph Samet et al., *Multinational Insolvencies*, in COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES DEALING WITH FOREIGN WORKOUTS AND INSOLVENCIES 1993: PRACTICAL STRATEGIES FOR LENDERS AND INVESTORS, 671 PRAC. L. INST. 7, 28 (1993).



ings filed primarily to achieve such result, especially where the foreign guarantor's U.S. assets are insignificant in relation to its foreign assets.<sup>36</sup>

Another consideration that is not taken into account is Engen's and Cangen's relationship with the United States. It is not reasonable to allow Engen and Cangen to take advantage of U.S. bankruptcy laws if the only property Engen or Cangen hold in the United States is a small bank account. On the other hand, if there is substantial contact by Engen and Cangen to the United States, it seems more reasonable to use U.S. bankruptcy laws. By analogy, U.S. bankruptcy courts could utilize a "minimum contacts" test similar to that developed in federal jurisdiction cases.<sup>37</sup> Because U.S. bankruptcy courts are federal courts, the analogy seems reasonable. Therefore, in determining which country's laws to apply under the minimum contacts test, the court could look to a developed body of law. Utilizing the minimum contacts test would alleviate the need for U.S. bankruptcy courts to apply their usual ad hoc methods.

#### *B. U.S. Bankruptcy Ancillary Proceedings and the Principle of Comity*

Under 11 U.S.C. § 304, a foreign representative may request the U.S. bankruptcy court to recognize a foreign country's jurisdiction or law.<sup>38</sup> A section 304 proceeding would be likely if, for instance, a foreign creditor implemented an involuntary bankruptcy of the debtor in the foreign country. The U.S. bankruptcy court may either recognize the foreign country's jurisdiction or law, or dismiss the proceeding.<sup>39</sup> Unless the

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36. *Id.*

37. See *Helicopteros Nacionales de Colombia, S.A. v. Hall*, 466 U.S. 408 (1984); *Perkins v. Benguet Consolidated Mining Co.*, 342 U.S. 437 (1952).

38. Rosenthal, *supra* note 24, at §336 (stating that Congress enacted 11 U.S.C. § 304 to encourage U.S. courts to defer to foreign law).

Canadian law also allows for recognition of foreign claims based on the principle of comity. *Re Sefel Geophysical Ltd.*, 70 C.B.R. 97, 62 Alta. L.R.2d 193, 92 A.R. 51, (1989) 1 W.W.R. 251, 54 D.L.R. 4th 117 (Q.B.) (1988) (Can.); *Pitts v. Hill & Hill TruckLine, Inc.*, 53 Alta L.R.2d 219, 66 C.B.R. 273, (*application dismissed*) *sub nom* *Pitts v. Hill* 84 A.R. 333 (1987) (Can.). The Canadian Bankruptcy Act also accords the trustee "statutory power to act anywhere in the world to obtain possession of the bankrupt's property and to realize on it: subsection 12(6)." JOHN R. VARLEY, *THE EFFECT OF INSOLVENCY PROCEEDINGS ON CREDITOR REMEDIES* 4 (1988).

39. Melnik, *supra* note 19, at 230.

foreign countries bankruptcy laws are similar to the United States bankruptcy laws, however, courts are unlikely to utilize foreign laws.<sup>40</sup>

The policies of 11 U.S.C. § 304(c) encourage bankruptcy courts to engage in an ad hoc balancing of competing interests to determine which law to apply.<sup>41</sup> The courts are "guided by what will best assure an economical and expeditious administration of such estate . . . ."<sup>42</sup> Six factors used in the ad hoc balancing are:

- (1) just treatment of all holders of claims against or interests in such estate;
- (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
- (3) prevention of preferential or fraudulent dispossession of property of such estate;
- (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;
- (5) comity; and
- (6) if appropriate, the provision of an opportunity for a fresh start for the individual whose foreign proceeding concerns.<sup>43</sup>

If foreign law is recognized, the U.S. bankruptcy court may have difficulty administering the estate due to the different policy concerns of different countries, the dispositions of the estate, and the way in which the issues of insolvency and fraudulent transfers are determined.<sup>44</sup>

J. H. Dalhuisen, a bankruptcy scholar, promotes the use of the foreign country's laws, stating:

If one assumes that foreign and local creditors are always treated equally and may recover everywhere . . . the foreign creditors should have resort to local . . . actions against whatever transaction or asset might be reached thereunder in any particular jurisdiction and the foreign action may not need

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40. Knecht, *supra* note 3, at 288.

41. 11 U.S.C. § 304(c) (1988 & Supp. V 1993); Westbrook, *supra* note 11, at 37 ("the listing of 'comity' as one of the factors to be considered, although doubtless intended to reinforce the policy of deference, can have the perverse effect of making comity seem just one more factor to be weighed.").

42. *Id.*

43. 11 U.S.C. § 304(c).

44. DALHUISEN, *supra* note 13, at 3-409 to 3-411.

contemplation, at least not outside bankruptcy proceedings .

. . .<sup>45</sup>

According to Dalhuisen, "accommodating the true bankruptcy conflicts . . . will largely depend to what extent the adjudicating court, short of statutory or treaty law to the effect, may conceivably make concessions in order to take care of the foreign interests involved."<sup>46</sup>

If a foreign country's bankruptcy or accounting standards are used, there may be dissimilar results in a fraudulent transfer action because of the resulting solvency or insolvency of a debtor. U.S. bankruptcy courts may have difficulty interpreting a foreign country's statutes and cases; similar language does not mean similar interpretations or policies.<sup>47</sup> Although concerned about comity, U.S. bankruptcy courts are wary about determining the meaning of individual states' laws, much less the laws of other countries.<sup>48</sup> U.S. courts are in conflict when it comes to whether they should recognize foreign laws. While some bankruptcy courts have followed foreign law,<sup>49</sup> others have allowed foreign debtors to take advantage of U.S. law.<sup>50</sup>

#### IV. FRAUDULENT TRANSFERS, INSOLVENCY, GUARANTY VALUATION, AND OUTCOMES

In determining whether a transaction was constructively fraudulent,<sup>51</sup> and therefore avoidable, the bankruptcy court will

45. *Id.* at 3-340. Dalhuisen further notes that "the effects on the ordinary course of business and interested parties in the place of enforcement need to be considered and balanced, and this applies all the more so to extraterritorial effects of bankruptcy at large." *Id.*

46. *Id.* at 3-409.

47. Westbrook, *supra* note 3, at 481-82.

48. DALHUISEN, *supra* note 13, at 3-268.

49. *In re Gee*, 53 B.R. 891, 896, 904 (Bankr. S.D.N.Y. 1985); *In re Metzeler*, 78 B.R. 674, 677 (Bankr. S.D.N.Y. 1987).

50. *In re Egeria Societa Per Azioni di Navigazioni*, 26 B.R. 494, 497 (Bankr. E.D. Va. 1983); *In re Comstat Consulting Serv., Ltd.*, 10 B.R. 134, 135 (Bankr. S.D. Fla. 1981).

51. According to Norberg:

Section 548(a)(2) permits the trustee to avoid transfers and obligations that are deemed constructively fraudulent. A transfer or obligation is constructively fraudulent if it was made or incurred (1) "on or within one year before the date of the filing of the petition," (2) in exchange for "less than a reasonably equivalent value," (3) at a time when the debtor was in poor financial condition. Under Section 548(a)(2), the trustee need not prove actual intent to defraud creditors.

Norberg, *supra* note 8, at 1102.

determine whether Engen and Cangen became insolvent when they incurred or satisfied the guaranty obligation.<sup>52</sup> In determining whether Engen and Cangen were insolvent, it is unlikely that U.S. bankruptcy courts would use the foreign country's accounting practices as opposed to U.S. bankruptcy law. U.S. bankruptcy and circuit courts decline to use U.S. Generally Accepted Accounting Principles (G.A.A.P.), much less the accounting principles of another country.<sup>53</sup>

In order for the trustee to prove Engen and Cangen insolvent, the trustee must determine the amount of debt on their respective balance sheets. The resulting balance sheet is not the actual corporate balance sheet used for the corporation's accounting purposes, rather it is for the Court's use in determining whether the transfer was avoidable. The guaranty from Engen and Cangen to Genbank will be listed as a debt on each of their balance sheets. A main concern is whether the entire guaranty, part of the guaranty or none of the guaranty should be listed as a debt on the balance sheet. If the full guaranty is listed, then it is more likely that Engen or Cangen became insolvent due to the transaction, thus allowing the trustee to void the transaction. If only part or

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52. Other countries determine if a transaction was a fraudulent transfer by dissimilar methods:

a. In France, the presumptive period for insolvency is eighteen months prior to the debtor's bankruptcy filing. Those categories for which the transfer will be void *per se* include transfers for less than full value and payments of matured debt in a manner other than an established means of payment. Other acts that are voidable include payments for valuable consideration where the lender knew of the debtor's cessation of payments.

b. In Belgium and Luxembourg, the presumptive period for insolvency is six months prior to the debtor's bankruptcy filing. These countries closely follow the French system and also use the specified categories for void and voidable transactions.

c. In West Germany, the period in which transfers may be deemed fraudulent is six months prior to the debtor's bankruptcy filing. There is no presumption that any transfers are void *per se*. Transactions may not be voided unless the transaction caused damage to the creditors as a whole.

d. In the Netherlands, the presumptive period is only forty days prior to the debtor's bankruptcy filing. There are only three transactions that may qualify for this presumption: transactions for inadequate consideration, transactions where the debtor grants the lender a security interest for a pre-existing debt, and transactions with family members.

e. In Italy, there is a complex system of "suspect" periods. The Italian system focuses on the beneficiary's knowledge that the debtor was insolvent. If the trustee can prove the beneficiary's knowledge, the trustee can look back for a period of one year prior to the debtor's bankruptcy filing for some transactions, and two years for others.

DALHUISEN, *supra* note 13, at 3-329 to 3-340.

53. See *infra* discussion Part IV.A.2. and Part IV.A.3.

none of the guaranty is listed, it is more likely Engen or Cangen will be deemed solvent, thus making the transfer valid.

The way in which the guaranty is listed on Engen's and Cangen's balance sheets may determine whether Engen and Cangen were solvent at the time of the transfer.<sup>54</sup> Bankruptcy courts could value guaranties in three ways. First, because Genbank realized the full value of the guaranties from Engen and Cangen, it seems appropriate to list the entire guaranty on Engen's and Cangen's respective balance sheets as a liability. With the full value of the guaranty listed on their balance sheets, it is more likely that Engen and Cangen would appear insolvent at the time the transfer was made.<sup>55</sup> If Engen or Cangen is deemed to have been insolvent at the time the transfer occurred, the transaction would be considered fraudulent, and Genbank would be required to return the funds obtained from Engen and Cangen to the bankruptcy estate.<sup>56</sup> Allowing the full amount of the guaranty on the balance sheet may appear to be a better approach because, in hindsight, the full amount was actually paid. Additionally, this calculation has the benefit of certainty and easy application.

A second approach courts could take is to determine that, at the time Engen and Cangen gave Genbank their guaranties, it was not certain that they would be required to pay any liability due to the guaranty. In making this valuation determination, the court could allow Cangen to list less than the full amount of the guaranty on their balance sheet. By listing a partial amount on their balance sheets, Engen and Cangen would be more likely to appear solvent at the time of the transfer than if the full amount is listed. Therefore, Genbank would not be required to return the assets received under the guaranties if the court finds Engen and Cangen solvent.<sup>57</sup>

Under the third approach, the court could consider valuing the guaranties to be too speculative, and, therefore, place the value of

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54. To determine insolvency, the court will consider whether the debtor was in poor financial condition before, or as a result of, the transaction. Financial condition may be determined by analyzing whether the debtor was insolvent (e.g., where liabilities exceed assets), whether the debtor was undercapitalized, and whether the debtor's subjective belief about its ability to pay its debts as they matured. 11 U.S.C. § 548(a) (1988 & Supp. V 1993).

55. The full amount of the guaranty would be, of course, greater than a partial amount or no amount of the guaranty.

56. BLUM, *supra* note 10, at 309.

57. *See infra* Part IV.A.3.

the guaranty at zero. An alternative reason for valuing the guaranty at zero is a subsequent full value payment of the loan by Pargen to Genbank. Thus, Engen's and Cangen's debt would be effectively nullified. Engen and Cangen have the greatest chance of appearing solvent under this approach. This calculation has the benefit of definiteness and easy application.

The United States, the United Kingdom, and Canada each view fraudulent transfers, insolvency, and guaranty valuation differently. Each country's view reflects the policies on which its bankruptcy system is based.

*A. The U.S. View of Fraudulent Transfers, Insolvency, and Guaranty Valuation*

**1. U.S. Fraudulent Transfers**

Under U.S. bankruptcy law, the transfer of assets from the subsidiaries, Engen and Cangen, to Genbank may be considered fraudulent if Engen or Cangen became insolvent by incurring the obligation or by honoring their guaranties.<sup>58</sup> If one or both of the transfers are considered fraudulent, the trustee could avoid the transfers and force Genbank to turn over the money or assets it received from Engen and Cangen to the bankruptcy court for the benefit of Engen's and Cangen's creditors.<sup>59</sup>

Section 548(a), which governs fraudulent transfers in the United States, provides as follows: "The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition . . . ."<sup>60</sup>

Pursuant to section 548, a trustee may show that a transfer was fraudulent in two ways. Under the first method, the trustee would have to prove the debtor had actual fraudulent intent.<sup>61</sup>

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58. In the United States, one of the elements of a fraudulent transfer is that the debtor must be insolvent. 11 U.S.C. § 548(a) (1988 & Supp. V 1993).

59. BLUM, *supra* note 10, at 309, 350.

60. 11 U.S.C. § 548 (1988 & Supp. V 1993).

61. According to 11 U.S.C. § 548(a)(1), the transfer can be avoided if the transfer was made within one year preceding the debtor's filing of bankruptcy with the "intent to hinder, delay, or defraud." *Id.* § 548(a)(1).

For the purposes of § 548(a)(1), the "solvency" of the debtor does not matter. Therefore, it does not matter whether the debtor is considered insolvent at the time of the transfer if the transfer was made with the intent to "hinder, delay, or defraud." *Id.*

Under the second method, the transfer can be avoided for several reasons, one reason being that the debtor was insolvent at the time of the transfer.<sup>62</sup> The lender may have a defense, however, such as the "reasonably equivalent value" defense or the "good faith/financial condition of the debtor" defense for the guaranty.<sup>63</sup> The transaction cannot reduce the debtor's net worth measured at the time the obligation was incurred,<sup>64</sup> and benefits received by the debtor/guarantor can be indirect.<sup>65</sup> Starting with *In re Rubin*,<sup>66</sup> the bankruptcy courts have accepted the "reasonably equivalent value" defense for upstream guaranties.<sup>67</sup> For purposes of this Comment, the second method is relevant to prove that the transfer was fraudulent, because this Comment does not address the intricacies of proving "intent."

Thus, under U.S. bankruptcy law, one of the determinative factors in ascertaining whether the transfer from Engen or Cangen was fraudulent is whether Engen or Cangen was insolvent at the

62. *Id.* § 548(a)(2). Section 548(a)(2) provides:

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . .

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B)(i) *was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;*

(ii) *was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or*

(iii) *intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.*

*Id.* (emphasis added).

63. Norberg, *supra* note 8, at 1102. According to Norberg:

A transfer or obligation is constructively fraudulent if it was made or incurred (1) "on or within one year before the date of the filing of the petition," (2) in exchange for "less than a reasonably equivalent value," (3) at a time when the debtor was in poor financial condition. Under section 548(a)(2), the trustee need not prove actual intent to defraud creditors.

*Id.*

64. Rasmussen, *supra* note 2, at 211. A recent preference case, however, stated that the court may look to what actually happened to determine value. *In re LCO Enterprises*, 12 F.3d 938 (9th Cir. 1993).

65. Some scholars argue that there should be a rebuttable presumption against the existence of a reasonably equivalent value. See Rasmussen, *supra* note 2, at 216.

66. *In re Rubin Bros. Foot Wear, Inc.*, 73 B.R. 346 (Bankr. S.D.N.Y. 1987).

67. See *In re Royal Crown Bottlers*, 23 B.R. 28, 30 (Bankr. N.D. Ala. 1982).

time the obligation was made or became insolvent due to the obligation or transfer.

## 2. U.S. Insolvency

U.S. and foreign bankruptcy courts define and determine insolvency differently.<sup>68</sup> In the United States, 11 U.S.C. § 101(32)(A) defines corporate insolvency as a condition where the corporation's debt is greater than all of the entity's property (assets) at fair market value.<sup>69</sup> Fraudulent transfers and exempt properties are not included on the balance sheet as either debts or assets when calculating whether a corporation is insolvent.<sup>70</sup> Therefore, whether Engen or Cangen will be considered insolvent depends on whether Engen's or Cangen's liabilities exceed their assets.<sup>71</sup> This test for insolvency is commonly called the "balance

68. According to Dalhuisen, methods of determining insolvency in other countries include:

- [1] In France, cessation of payments is required . . . .
- [2] In Belgium and Luxembourg equally the requirement is cessation of payments . . . [and] the additional requirement is that no more credit is available . . . .
- [3] In Italy, insolvency (cessation of payments) is defined as the inability of the debtor to regularly fulfill his obligations . . . to be deduced from the behavior of the debtor or the circumstances . . . .
- [4] In West Germany the opening ground is normally cessation of payments . . . a situation in which, because of continued lack of funds, the debtor finds himself unable to effectively meet his maturing obligations . . . economic insolvency also suffices.
- [5] In the Netherlands, finally, cessation of payments requires notably a plurality of creditors awaiting payments so that a concursus creditorum results . . . economic insolvency being notably not required but it is a sufficient ground for bankruptcy of decedent's estates . . . .

DALHUISEN, *supra* note 13, at 3-319 to 3-320.

Insolvency is not always required to file for bankruptcy in the United States, as illustrated by the case of a voluntary petition.

For involuntary straight bankruptcy petitions, insolvency is required, which is also the case for Chapter 11 involuntary petitions. For purposes of opening the proceedings, insolvency is now defined in [section] 303(h) as the debtor generally not paying his debts as they mature (and not through the balance sheet test of 11 [U.S.C.] § 101(26) which is used for other purposes, notable for the avoidance provisions). The sole other ground is the surrender of virtually all of the property of the debtor to a custodian within 120 days before the date of filing. No such insolvency test or appointment of a custodian is necessary for voluntary petitions. ([§§] 301, 303(h)).

*Id.* at 3-319.

69. 11 U.S.C. § 101(32)(A) (1988 & Supp. V 1993).

70. *Id.* § 101(32)(A)(i).

71. 11 U.S.C. § 101(32) states:

"[I]nsolvent" means—

(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all



sheet test" and differs from the test of insolvency in equity.<sup>72</sup> Whether Engen's or Cangen's liabilities exceed their assets, may depend on how the bankruptcy court values the guaranties that Engen and Cangen made to Genbank.

### 3. Guaranty Valuation in the United States

The "balance sheet test" treats a guaranty as contingent liabilities on the debtor's balance sheet.<sup>73</sup> The amount of the guaranty included on the balance sheet can have an impact on whether or not a corporation will be deemed insolvent. If a corporation is insolvent, the trustee could possibly avoid the transfer of assets as a fraudulent transfer.

In the United States, several circuit courts allow guaranties to be listed on balance sheets as contingent liabilities.<sup>74</sup> As a contingent liability, the full value of the guaranty is not listed on the balance sheet.<sup>75</sup> Alternatively, other circuit courts have ruled that the contingent liability, or asset, should be discounted by the probability the contingency will occur.<sup>76</sup>

In *In re Xonics, Photochemical Inc.*, the Seventh Circuit stated in dicta that contingent liabilities, which include guaranties, should not be valued on the balance sheet at face value.<sup>77</sup> In its exam-

of such entity's property, at a fair valuation, exclusive of -

- (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
- (ii) property that may be exempted from property of the estate under section 522 of this title . . . .

72. In equity, a corporation is deemed insolvent if it is unable to pay its debts as they come due. *Finn v. Meighan*, 325 U.S. 300, 303 (1944); *In re Frigitemp Corp.*, 34 B.R. 1000 (Bankr. S.D.N.Y. 1983), *aff'd* 753 F.2d 230 (2d Cir. 1985); *In re Keydata Corp.*, 37 B.R. 324 (Bankr. D. Mass. 1983).

73. Norberg, *supra* note 8, at 1117.

74. *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 200 (7th Cir. 1988); *In re Sierra Steel, Inc.*, 96 B.R. 275, 279 (9th Cir. 1989).

75. *Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 657 (7th Cir. 1992).

76. *Xonics*, 841 F.2d at 200. Judge Posner further stated in dicta: "the asset or liability must be reduced to its present, or expected, value before a determination can be made whether the firm's assets exceed its liabilities." *Id.* For the theory that the full value of a contingent liability should be listed on the balance sheet, see Norberg, *supra* note 8, at 1112-21. The court in *Xonics* specifically addressed this question and found that argument unpersuasive. *Xonics*, 841 F.2d at 200.

77. *Xonics*, 841 F.2d at 200. The court stated:

There is a compelling reason not to value contingent liabilities on the balance sheet at their face amounts, even if that would be possible to do because the liability, despite being contingent, is for a specified amount (that is, even if there is no uncertainty about what the firm will owe if the contingency materializes). By definition, a contingent liability is not certain—and often is highly unlike-

ple, however, the court multiplied the percentage of the likelihood that the contingent liability would become a certainty by the value of the assets on the balance sheet, instead of the value of the contingent liability itself.<sup>78</sup> The result of such an approach would be that no corporation would ever be insolvent.<sup>79</sup>

In *Xonics*, the issue was whether Xonics Photochemical, the debtor/guarantor, was insolvent at the time that it made payments to Mitsui & Co., a supplier of chemicals.<sup>80</sup> Xonics Photochemical had executed guaranties for the debt of Xonics, Inc., the parent corporation, and other subsidiaries of Xonics, Inc., including Xonics Medical Systems.<sup>81</sup> The dispositive issue for this study was how the contingent liability of the guaranty should be listed on the debtor's balance sheet; the method of listing the guaranty determined whether the debtor was insolvent at the time of the transfer.<sup>82</sup> The *Xonics* court stated that the contingent liability would be discounted by the probability that the contingency would occur.<sup>83</sup> The example the court used to illustrate the concept was:

Suppose that on the date the obligations were assumed there was a 1% chance that Xonics Photochemical would ever be called on to yield up its assets to creditors of Xonics Medical Systems (or other members of the Xonics family, since the system of guaranties had the effect of pooling its assets for the benefit of creditors of any member). Then the true measure of

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ly-ever to become an actual liability. To value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real.

*Id.*

78. *Id.*

79. *Id.*

80. *Id.* at 199.

81. *Id.* at 199.

82. *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 200 (7th Cir. 1988).

83. For a proposal of a more accurate valuation method, see Rasmussen, *supra* note 2, at 212. Rasmussen uses expected value calculations of *all* the probabilities and contingencies. Thus, instead of stating there was a 10% chance that the debtor would be required to pay a \$1,000,000.00 guaranty, which would result in the guaranty being listed on the balance sheet as \$100,000.00, Rasmussen would calculate the guaranty as follows: 10% chance of the debtor being required to fully pay the guaranty, 15% chance that the debtor would be required to repay 75% of the loan, 20% chance that the debtor would be required to repay 50% of the loan, 20% chance that the debtor would be required to pay 25% of the loan, and 35% chance that the debtor would not need to pay any of the loan. Thus, in calculating: \$100,000.00 + \$112,500.00 + \$100,000.00 + \$50,000.00 + \$0.00 = 362,500.00. For a more detailed calculation, see Rasmussen, *supra* note 2, at 212.

the liability created by these obligations on the date it was assumed would not be \$28 million; it would be a paltry \$17,000. For at worst Xonics Photochemical would have to yield up all of its assets (net of other liabilities), that is, \$1.7 million, and the probability of this outcome is by assumption only 1 percent (we are ignoring intermediate possibilities—e.g. that Xonics Photochemical would be forced to cough up \$1 million rather than \$1.7 million). Discounted, the obligations would not make Xonics insolvent . . . .<sup>84</sup>

The court further stated that whether the corporation was solvent at the time of the transfer was not at issue because all parties agreed that if the guaranty was a valid obligation, then the debtor was insolvent.<sup>85</sup> Thus, because the guaranty was a valid obligation, insolvency was presumed. The court erred in using the corporate assets to determine solvency or insolvency.<sup>86</sup> By using the assets net liabilities, the court would never find any corporation insolvent, unless it was insolvent without the guaranty at the time the guaranty was given.<sup>87</sup>

The Seventh Circuit corrected the error of the *Xonics* court and applied the issue of insolvency in *Covey v. Commercial Nat'l Bank of Peoria*.<sup>88</sup> In *Covey*, the trustee brought an adversary proceeding to avoid the lender's collection on a guaranty.<sup>89</sup> Commercial National Bank of Peoria ("Bank") had made a loan to Jobst Corporation ("Parent") and only obtained guaranties from Parent's subsidiary corporations, including V. Jobst & Sons.<sup>90</sup> When Parent went bankrupt, V. Jobst & Sons' assets were sold, and Bank collected the receivables under the guaranty.<sup>91</sup> The

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84. *Xonics*, 841 F.2d at 200.

85. *Id.* at 199.

86. *Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 675, 660 (7th Cir. 1992).

87. *Id.* As noted by the court in *Covey*:

If we use net assets as the maximum value of a contingent liability, it follows that no contingent liability ever renders any firm insolvent. A \$5 million note issued by a firm with \$4 million in assets propels the firm into insolvency, but a \$5 billion guarantee by the same firm, on which the beneficiary is a 99% certain draw, would not: instead of multiplying \$5 billion by 0.99, the court would multiply \$4 million by 0.99. Yet all would concede that, from the debtor's perspective, the guarantee is more costly than the unconditional note.

*Id.*

88. *Id.* at 657.

89. *Id.* at 658-59.

90. Jobst had been created as a holding company, and its only asset was the stock of its subsidiaries. *Id.* at 658.

91. *Covey*, 960 F.2d at 658.

trustee tried to recover those assets from Bank. The trustee argued that there was a fraudulent transfer because the transfer from the subsidiary to Bank was made while the subsidiary was insolvent.<sup>92</sup> The issue was how the value of the contingent liability/guaranty would be listed on the balance sheet.<sup>93</sup> The value of the guaranty would thus determine whether V. Jobst & Sons was insolvent when the transfer of assets to Bank occurred.<sup>94</sup>

The district court held there was a sixty percent chance that the parent corporation would default, allowing the bank to collect on the guaranty from the subsidiary.<sup>95</sup> The appellate court held that the percentage should be multiplied by the total amount of the contingent liability.<sup>96</sup> When applied to the balance sheet, the calculation left the debtor insolvent, and therefore the transfer was avoided.<sup>97</sup> This application allowed the court to conclude that the corporation was insolvent at the time of the guaranty.<sup>98</sup> As the court stated, "[t]he Bankruptcy Code requires us to assess things from the debtor's perspective."<sup>99</sup>

*Covey* is also important because it acknowledged *Xonics'* departure from standard accounting practices, but stated that the departure was not pertinent.<sup>100</sup> The court held that the perti-

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92. *Id.* at 659.

93. *Id.* at 658.

94. *Id.* at 660.

95. *Id.* at 659.

96. *Covey*, 960 F.2d at 660.

97. The Bank tried to argue that the percentage should be multiplied by the value of V. Jobst & Sons's assets. The court disagreed, however, noting that *Xonics'* figures were only illustrative, not decisive. The court further stated: "If we use net assets as the maximum value of a contingent liability, it follows that no contingent liability ever renders any firm insolvent." *Id.* at 660.

98. *Id.* The court's analysis included the following example:

The Bankruptcy Code requires us to assess things from the debtor's perspective. Consider a simple case. Debtor issues its note for \$10 million. It has assets of \$5 million, secured debt of \$2 million, and no other debt. From the creditor's perspective this note is worth somewhat less than \$3 million. (Collection is costly and uncertain.) Together, Debtor's creditors place a value of less than \$5 million on its commitments. Nonetheless, Debtor is insolvent. Against assets of \$5 million there are claims of \$12 million. Now turn the \$10 million note into a guarantee of a parent corporation's \$50 million debt, coupled with a probability of 20% that the Debtor will be called on to pay. The two commitments are economically equivalent:  $\$10,000,000 = \$50,000,000 \times .02$ .

*Id.*

99. *Id.*

100. *Covey*, 960 F.2d at 660; see also *In re Sierra Steel, Inc.*, 96 B.R. 275, 278-79 (9th Cir. 1989). In *Sierra*, the Ninth Circuit determined whether a debtor was insolvent at the

nent question was: "[w]hat would a buyer be willing to pay for the debtor's entire package of assets and liabilities? If the price is positive, the firm is solvent; if negative, insolvent."<sup>101</sup>

Thus, in the United States, G.A.A.P. are not controlling and bankruptcy judges are the arbiters of how insolvency is determined. Currently, most bankruptcy courts follow the *Xonics-Covey* standard for determining solvency: the likelihood that the guarantor corporation will be called upon to back up its guaranty multiplied by the total contingent liability to determine solvency.<sup>102</sup>

U.S. bankruptcy courts approach guaranties subjectively. The bankruptcy court, supposedly without hindsight, determines the likelihood of the parent corporation defaulting on the guaranty. The calculation is an imprecise figure when calculated by a financial statistician, much less by the judiciary.

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time of transfer. *Sierra*, 96 B.R. at 278-79. The DIP, Sierra Steel, Inc., filed an adversary proceeding seeking to recover a transfer made to Totten Tubes, Inc., due to Sierra's "insolvency" at the time of the transfer. The transfer occurred eighty-seven days prior to Sierra's filing a bankruptcy petition under Chapter 11. Although the court upheld the "balance sheet test," it also held that, Generally Accepted Accounting Principles (G.A.A.P.) were not controlling:

The authorities cited by the debtor do not compel the conclusion that the bankruptcy court must follow G.A.A.P. in making solvency determinations. Requiring application of G.A.A.P. would make accountants and the board which promulgate G.A.A.P. the arbiters of insolvency questions. Clearly the Code provides that judges should make such decisions. . . . Thus although G.A.A.P. are relevant, they are not controlling in insolvency determinations.

*Sierra*, 96 B.R. at 278.

In *Sierra*, the court deleted the contingent liability of a claim in litigation because it considered the debt, a tax liability, as having no probability of becoming real because the debtor was operating at a loss. The debt was not included in determining solvency. *Sierra*, 96 B.R. at 228-89.

101. *Covey*, 960 F.2d at 660; see also *In re Parker Steel Company*, 149 B.R. 834, 845 (Bankr. N.D. Ohio 1992) (stating "[i]n valuing Debtor's liability . . . although G.A.A.P. are relevant, they are not controlling.").

102. See *In re Alper-Richman Furs, Ltd.*, 147 B.R. 140 (Bankr. N.D. Ill. 1992), *In re Davis*, 148 B.R. 165 (Bankr. E.D.N.Y. 1992).

But see *In re Parker Steel Company*, 149 B.R. 834, 838-45 (Bankr. N.D. Ohio 1992) (allowing only \$1,208,255 in contingent liabilities rather than the \$1,500,000 listed on the debtor's balance sheet. This contingent liability arose from a pre-petition lawsuit seeking damages for breach of contract due to Parker's failure to deliver a shipment of steel. Thus, in *Parker*, by utilizing a figure to which the parties stipulated was the fair or present value, the court avoided the *Xonics* error).

#### 4. The Consequences of U.S. Bankruptcy Law

If U.S. bankruptcy courts use U.S. bankruptcy laws, the domestic creditors of both Engen and Cangen will be treated equally, because the same principles and laws apply to both bankruptcies.<sup>103</sup> If the bankruptcy court determined that the likelihood of Pargen defaulting on its loan to Genbank was twenty percent, the following balance sheets result (in millions):

ENGEN		CANGEN	
ASSETS	LIABILITIES	ASSETS	LIABILITIES
100	75	100	75
	Guaranty		Guaranty
	20		20
	*Equity*		*Equity*
	5		5

Thus, at the time of the guaranty, both Engen and Cangen would be considered solvent, and the transfer would not be considered fraudulent. Note, however, that if the percentage is increased by as little as six percent, a contrary outcome will result.

#### *B. The U.K. View of Fraudulent Transfers, Insolvency, and Guaranty Valuation*

##### 1. U.K. Fraudulent Transfers

By applying U.S. law, the U.S. bankruptcy court may frustrate foreign bankruptcy policies. The different outcome that results

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103. Foreign creditors, however, may find themselves subject to 11 U.S.C. § 508(a) (1988 & Supp. V 1993). According to some bankruptcy scholars:

Section 508(a), which appears to have been the subject of no reported cases to date, provides that creditors receiving distributions in foreign proceedings may not receive distributions in U.S. proceedings on such claims until other creditors with claims in the U.S. proceedings have received equal amounts.

Samet et al., *supra* note 35, at 25.

from applying foreign law can be illustrated by applying U.K. bankruptcy law to Engen's bankruptcy. U.K. bankruptcy law is governed by chapter 45 of the Insolvency Act of 1986. Under U.K. law, fraudulent transactions are combined with preferences as transactions at an undervalue. Section 238 of chapter 45 of the Insolvency Act of 1986 provides:

(4) For the purposes of this section . . . a company enters into a transaction with a person at an undervalue if . . . (b) the company enters into a transaction with that person for consideration the value of which, in money or money's worth, significantly less than the value, in money or money's worth, of the consideration provided by the company.<sup>104</sup>

The Insolvency Act of 1986 discusses preferences in section 239:

(4) For the purposes of this section . . . a company gives a preference to a person if—(a) that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities, and (b) the company does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done.<sup>105</sup>

A "trustee" in the United Kingdom can recover property the debtor had transferred up to six months prior to the debtor's bankruptcy filing or up to two years if the transfer was given to "a person who is connected with the company."<sup>106</sup> Additionally, both section 238 and 239 are conditioned by section 240, which limits whether a transaction will be "at an undervalue" to those where the debtor is insolvent.<sup>107</sup> Generally, the burden of proof is on the trustee to show that the debtor was insolvent.<sup>108</sup> This presumption is reversed, however, if the transfer is made to a person connected with the company.<sup>109</sup>

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104. Insolvency Act, 1986, ch. 45, § 238(4)(b) (Eng.).

105. *Id.* § 239(4)(a), (b).

106. *Id.* § 240(1)(a), (b).

107. *Id.* § 240(2)(a), (b).

108. *Id.* § 240(2)(b).

109. *Id.* § 240(2).

## 2. U.K. Insolvency

In the United Kingdom, a debtor is considered insolvent if it is unable to pay its debts as they become due.<sup>110</sup> This "test" for insolvency can be applied in one of three ways: (1) if a debtor is unable to pay its debts as they become due, (2) if a debtor's liabilities exceed its assets, or (3) if a debtor does not pay an obligation within a specified period.<sup>111</sup> As previously noted, for preferences and fraudulent transfers, the transfer must have occurred at a time the company was insolvent or the transaction must have made the company insolvent.<sup>112</sup> Like the process in the United States, whether Engen is insolvent *may* turn on how the guaranty is valued on Engen's balance sheet. Unlike the United States, however, insolvency is not limited to the balance sheet test.

## 3. Guaranty Valuation in the United Kingdom

The United Kingdom espouses the view of some U.S. bankruptcy courts that it is either difficult or speculative to value guaranties. In one U.K. tax case considering the valuation of guaranties, the taxpayer's counsel and Special Commissioner argued that it was "quite impossible to place a rational value on guarantees. In effect the rather speculative submissions of the Crown's representative on this topic bear this out. How do you value the guarantees in monetary terms? I do not think you can."<sup>113</sup> The court agreed, stating: "there was no basis on which a separate and additional monetary value could be placed on the guarantee as part of the consideration to be added to the undoubted monetary price paid which was the true open market price . . ."<sup>114</sup> According to U.K. courts, the guaranties could not be valued because there was no market.<sup>115</sup>

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110. *Id.* § 268.

111. DENNIS CAMPBELL, INTERNATIONAL CORPORATE INSOLVENCY LAW 138-39 (1992).

112. Insolvency Act, 1986, ch. 45, § 240(2)(a), (b) (Eng.).

113. *Fielder v. Vedlynn, Ltd.*, 1992 S.T.C. 553 (Eng.). Although this was a tax case, the reasoning is analogous to the bankruptcy context.

114. *Id.*

115. *Id.*



In the United Kingdom, subject to the debtor's right to appeal, the trustee can estimate the value of guaranties.<sup>116</sup> Nonetheless, if the lender claims the full amount of the debt from the guarantor, and the principal debtor makes payments, the lender may not receive more than the full amount of the debt.<sup>117</sup> Thus, if U.K. law is used for Engen's bankruptcy, Genbank may claim the full amount of the guaranty in Engen's bankruptcy. If Pargen subsequently pays part or all of its debt to Genbank, however, Genbank cannot additionally obtain the full amount of the claim from the distribution of Engen's bankruptcy estate.

#### 4. The Consequences of U.K. Bankruptcy Law

Under U.K. bankruptcy law, Engen's guaranty could be valued in one of two ways: (1) the guaranty could be valued at zero, or (2) the court could estimate the value. If the U.S. bankruptcy court estimates the value of the guaranty pursuant to an ancillary proceeding, it seems likely that its calculation would be similar to the one used in U.S. bankruptcies. Therefore, the estimate of twenty percent is used here.

The resulting balance sheets would appear as follows (in millions):

ENGEN (U.K. ZERO VALUE)		ENGEN (U.K. PERCENT VALUE)	
ASSETS	LIABILITIES	ASSETS	LIABILITIES
100	75	100	75
	Guaranty		Guaranty
	0		20
	*Equity*		*Equity*
	25		5

Thus, under U.K. bankruptcy law, Engen could be considered solvent under the "balance sheet test." Engen could be considered

116. P.E. EALES & P.A.F. DE VOS, A GUIDE TO BANKRUPTCY 49, 55 (1978).

117. *Id.*

insolvent, however, under one of the other tests for insolvency regardless of their solvency under the balance sheet test. If Engen had not been paying its debts as they became due, U.K. bankruptcy courts would consider Engen insolvent and force Genbank to return the assets received from Engen. Therefore, U.K. bankruptcy law may allow recovery while U.S. bankruptcy law would not allow recovery.

*C. The Canadian View of Fraudulent Transfers, Insolvency, and Guaranty Valuation*

1. Canadian Fraudulent Transfers

By applying U.S. bankruptcy law, U.S. courts may frustrate Canadian bankruptcy policies. Applying Canadian bankruptcy law to Cangen's bankruptcy illustrates the different outcome(s).

Under Canadian law, debtors can file under the Act or the BIA.<sup>118</sup> Under the Act, there is no provision to recover payments.<sup>119</sup> A creditor cannot be forced to return payments received from the debtor, regardless of the debtor's insolvency.<sup>120</sup>

Under the BIA, there are four alternatives available that allow recovery of payments made by the debtor. First, "[a]ny settlement of property, if the settlor becomes bankrupt within five years after the date of the settlement, is void against the trustee if the trustee can prove that the settlor was, at the time of making the settlement, unable to pay all his debts . . . ."<sup>121</sup> Second, under the BIA a guaranty may be attacked as a preference if the transfer was made within three months prior to the insolvent debtor's bankruptcy filing.<sup>122</sup> Third, under the Fraudulent Conveyance Act, "[i]f the debtor's intent is fraudulently to prefer one or more of his creditors or (arguably) to defeat, hinder, delay, or prejudice the non-preferred creditors, the preference is commonly described

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118. Leonard & Marantz, *supra* note 27, at 304.

119. *Id.* at 317.

120. *Id.*

121. Bankruptcy Act., R.S.C., ch. B-3, § 91(2) (1985) (Can.). See Derrick C.A. Tay, *The Canadian Law of Guarantees: An Overview and Examination of Particular Canadian Issues for American Lawyers*, in COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES INTERNATIONAL AND DOMESTIC GUARANTIES AND OTHER COLLATERAL ASSURANCES OF PERFORMANCE, 501 PRAC. L. INST. 135, 161-66 (1989).

122. Tay, *supra* note 121, at 162-63.

as 'unjust' or 'fraudulent.'"<sup>123</sup> The trustee must prove that the debtor had the intent to prefer one creditor or guaranty over another.<sup>124</sup> The fourth method is under the Assignments and Preferences Act, which requires the joint intent "to both give and receive the fraudulent preference."<sup>125</sup>

## 2. Canadian Insolvency

The Canadian determinations of insolvency are similar to those of the United Kingdom. In Canada, a debtor can be found insolvent in three ways: (1) when a debtor is unable to meet its obligation as it becomes due; (2) when, in the ordinary course of business, the debtor is unable to meet its financial obligation as it becomes due; or (3) when, if all of the debtor's assets were liquidated, the debtor would not be able to cover its debts.<sup>126</sup> Thus, under Canadian law, Cangen could be considered insolvent, whether or not its liabilities exceeded its assets.

## 3. Guaranty Valuation in Canada

In Canada, it is not clear whether future obligations must be calculated.<sup>127</sup> The trustee must "put all such claims to the Bankruptcy Court for valuation."<sup>128</sup> This law has resulted in disparate holdings. In some instances, Canadian bankruptcy courts have held that only liquidated liabilities should be used to determine whether a debtor is bankrupt.<sup>129</sup> In other cases, however, the bankruptcy courts have held that the guaranty is considered an existing debt that attached at the moment it was conveyed.<sup>130</sup> There is, however, strong support that the guaranty should not be included on the balance sheet.<sup>131</sup>

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123. M.A. Springman, *Fraudulent Conveyances, Fraudulent Preferences, and other Voidable Transactions*, in RIGHTS AND REMEDIES IN THE LAW OF CREDITOR AND DEBTOR 59, 60 (1988).

124. Bankruptcy Act, R.S.C., ch. B-3, § 91 (1985) (Can.). See Springman, *supra* note 123, at 104-20 (proving fraudulent intent of the debtor).

125. Tay, *supra* note 121, at 165.

126. Bankruptcy Act, R.S.C., ch. B-3, § 2 (1985) (Can.). See Springman, *supra* note 123, at 92, 159.

127. Springman, *supra* note 123, at 92.

128. Bankruptcy Act, R.S.C., ch. B-3, § 121(2) (1985) (Can.).

129. See *Union Bank v. Tyson*, 7 W.W.R. 1117, 1120 (1915) (B.C.S.C. Can.); Springman, *supra* note 123, at 92-93.

130. See *Traders Group, Ltd. v. Mason* 10 N.S.R.2d 135, 43 D.L.R.3d 76, 95 (1973) (Can.), *varied* 10 N.S.R.2d 115, 53 D.L.R.3d 103, 108 (1974) (Can.).

131. Tay, *supra* note 121, at 150-51.

#### 4. The Consequences of Canadian Bankruptcy Law

Under Canadian bankruptcy law, it is probable that the guaranty would not be listed on the balance sheet, and therefore, under the balance sheet test, the debtor would be more likely to be found solvent. Thus, the balance sheet might appear as follows (in millions):

<b>CANGEN</b>	
<b>ASSETS</b>	<b>LIABILITIES</b>
100	75
	Guaranty
	0
	*Equity*
	25

As illustrated above, if Canadian bankruptcy law is applied, Cangen may be considered solvent under the balance sheet test. As in U.K. law, however, there are alternative methods for determining insolvency under Canadian law. Although Cangen may pass the "balance sheet test," it may not pass on one of the other insolvency tests. Thus, Canadian bankruptcy law may allow recovery, a result that would be in direct conflict with U.S. bankruptcy law.

#### V. IMPACT OF THE USE OF ALTERNATIVE METHODS IN VALUATION OF GUARANTIES

As seen above, not all countries treat contingent liabilities (guaranties) the same as the United States.<sup>132</sup> According to some commentators:

United States bankruptcy laws . . . would permit foreign subsidiaries of United States corporations to file for bankruptcy with relatively minimal United States contacts and enable United States bankruptcy courts to assert jurisdiction over all assets of

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132. See *supra* Part IV.B.

the foreign debtor, wherever located (including property located outside the United States). Here, the potential for conflict between United States and foreign bankruptcy laws is great.<sup>133</sup>

Because the U.K. and Canadian tests for fraudulent transfers and insolvency differ from those used in the United States, a corporation in the United Kingdom or Canada may be considered insolvent even if its assets are greater than its liabilities. Thus, Engen or Cangen may be considered insolvent if either is unable to pay their obligations as they become due.<sup>134</sup> Also, as indicated, the Act does not appear to allow recovery of any pre-bankruptcy transfers.

Conversely, in the United States, a "corporation may be solvent for Bankruptcy Act purposes, even though it is unable to meet current liabilities, as long as the fair valuation of its assets is sufficient to meet its debts."<sup>135</sup> This distinction is significant because in U.S. bankruptcy law one of the prerequisites for determining a transfer fraudulent is that the debtor must have been insolvent at the time of the transfer.<sup>136</sup> Not allowing recovery unless the debtor is insolvent reflects U.S. bankruptcy policy that debtors should be free to distribute assets as they deem best. Only after a debtor becomes insolvent will a U.S. bankruptcy court become concerned that the debtor will favor one creditor over another, and the policy of equitable treatment of creditors become effective.<sup>137</sup>

U.S. bankruptcy policy can be contrasted with the policies of the United Kingdom and Canada by considering the impact that U.S. bankruptcy law will have on the debtor's foreign and domestic creditors.

### *A. Impact of Using U.S. Bankruptcy Standards*

There are many reasons why bankruptcy courts may decide to apply U.S. bankruptcy law in Engen's or Cangen's bankruptcy. First, pursuant to U.S. bankruptcy policy, Engen and Cangen are

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133. *Filcs & Ireland*, *supra* note 7, at 416.

134. For instance, companies may become unable to pay their debts as they become due when their assets are non-liquid (e.g., inventory, lagging accounts receivable, or machinery and equipment).

135. *In re Frigitemp Corp. v. Alpha Assoc., Inc.*, 34 B.R. 1000, 1005 (Bankr. S.D.N.Y. 1983). See also *Cohen v. Sutherland*, 257 F.2d 737, 741 (Bankr. 2d Cir. 1958).

136. 11 U.S.C. § 548 (1988 & Supp. V 1993).

137. *BLUM*, *supra* note 10, at 141.

not necessarily prohibited from "preferring" one creditor over another. The bankruptcy court may want to honor Engen's or Cangen's preference.<sup>138</sup> Additionally, despite the principles of comity and other balancing factors in ancillary proceedings, a large discrepancy under foreign law that favors foreign creditors may be disfavored by U.S. bankruptcy courts.

Under U.S. law, several factors affect whether a transaction will be avoidable.<sup>139</sup> As discussed *supra*, the way that guaranties are listed on a balance sheet may determine whether Engen or Cangen was insolvent at the time of the transfer and, therefore, whether the transfer was fraudulent and avoidable.<sup>140</sup> Under U.S. bankruptcy standards, the results could be contrary to the results under foreign bankruptcy practices due to the different valuations and standards of insolvency.

In determining liabilities on Engen's and Cangen's balance sheets under U.S. bankruptcy principles, the bankruptcy court determines, at the time the guaranty was made, the likelihood that the guaranty would be called by Genbank, and multiplies that percentage by the total amount of the guaranty. According to U.S. cases, the percentage determined by corporate insiders is not conclusive,<sup>141</sup> and hindsight may be used.<sup>142</sup> For example, bankruptcy judges may consider subsequent events in valuing

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138. Gropper, *supra* note 3, at 73 ("The U.S. principle is that, generally, an intercompany claim represents a legitimate debt of one company against the other and is not automatically subordinated or treated as equity, unless there is some reason to do so.").

139. For example, whether the transaction occurred during the period when Engen or Cangen is presumed insolvent determines whether the trustee can recover the payment. In the United States, if the transfer occurs outside the year-long period for insiders, the trustee will not be able to recover the transfer regardless of whether Engen or Cangen was insolvent at the time of the transfer. 11 U.S.C. § 548 (1988 & Supp. V 1993). This presumption of insolvency is rebuttable. Therefore, if Genbank, the beneficiary, is able to prove either Engen or Cangen was solvent at the time the transaction occurred, the transaction will not be avoidable. The main impact of the presumption is to transfer the burden of proof to Genbank.

Foreign law may also extend the time the courts allow recovery from transfers from ninety days in the United States to two years in the United Kingdom. See Stephen Gold, *In and Out of Bankruptcy*, 137 NEW L.J. 53, 53 (1987). In Canada, the period can extend to five years, longer if intent is proven. Tay, *supra* note 121, at 162-66. Allowing courts to extend the presumptive period of insolvency is contrary to U.S. bankruptcy policy, which favors debtors.

140. See *supra* Part III.

141. Covey v. Commercial Nat'l Bank of Peoria, 960 F.2d 657, 661 (7th Cir. 1992).

142. *In re Sierra Steel, Inc.*, 96 B.R. 275, 279 n.6 (9th Cir. 1989) (stating that "there is no policy reason why bankruptcy judges should not be allowed to consider subsequent events in valuing assets or determining liabilities.").

assets or determining liabilities. In an insolvency determination, a bankruptcy judge becomes a statistician in addition to administering other judicial responsibilities.

### 1. U.S. Bankruptcy Law—The U.K. Debtor

U.K. law indicates that the guaranty may not be considered when calculating Engen's liabilities.<sup>143</sup> As a result, under U.K. bankruptcy law, there is a higher probability that Engen will be considered solvent because no guaranty value is used as opposed to U.S. bankruptcy law, where a percentage of the guaranty is listed. Thus, U.K. bankruptcy policies may be thwarted under U.S. bankruptcy law because Engen would more likely be found insolvent if the risk that Pargen would default were higher than zero percent.

Conversely, if other factors are present, the court may consider Engen insolvent under U.K. bankruptcy law even if Engen's assets exceed its liabilities. Therefore, if the court finds Engen solvent under U.S. law and allows Engen to prefer Genbank, the result may frustrate U.K. bankruptcy policies.

### 2. U.S. Bankruptcy Law—The Canadian Debtor

Under Canadian law, recovery is not allowed under the Act. Not allowing recovery may reflect a Canadian policy of deferring to large corporations. Conversely, under the BIA, recovery is allowed and the time periods for recovery are extended.

By filing bankruptcy in the United States, however, Cangen may take advantage of U.S. court rulings, which allow a guaranty to be listed as a percentage of the likelihood that Cangen would be required to pay Pargen's debt.<sup>144</sup> Therefore, if Cangen does not qualify for the Act, it is advantageous for Cangen to file for bankruptcy in the United States. Under U.S. bankruptcy law, it is less likely that the transfer could be recovered. Thus, Cangen may prefer Genbank over other creditors, and Genbank would also benefit.

Under the BIA, Canadian courts ease the trustee's burden of proof that a transfer was fraudulent, allowing for a more equitable distribution of the estate among the creditors.<sup>145</sup> Allowing

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143. *Id.*

144. For a discussion of how guaranties are listed see *supra* Part III.

145. See Tay, *supra* note 121, at 161-66.

Cangen to prefer Genbank over another creditor is inconsistent with Canadian bankruptcy policies.

*B. Impact of Using Foreign Bankruptcy Standards in Ancillary Proceedings*

By applying foreign bankruptcy laws in an ancillary proceeding, U.S. bankruptcy courts may allow the trustee to avoid the transfers that would not be considered fraudulent under U.S. bankruptcy laws. For instance, since both U.K. and Canadian law define "insolvency" much more broadly than U.S. law, if their definition of insolvency is applied, it is more likely the trustee will avoid a transfer. Thus, the trustee may force Genbank to turn over assets collected from Engen or Cangen on an intercorporate guaranty as a fraudulent transfer due to the law chosen by the bankruptcy court.

Additionally, in ancillary proceedings, if the United States does not uphold the law of a foreign country, then that foreign country will probably not apply U.S. bankruptcy law when the situation is reversed. This factor is not considered under the U.S. balancing approach to decide which laws apply.

U.S. bankruptcy courts could analogize to U.S. tax cases, which prohibit the use of other (foreign) accounting methods that vary from U.S. accounting practices.<sup>146</sup> By solely using U.S. bankruptcy rules, the bankruptcy courts could favor U.S. creditors and debtors because foreign laws that were unfavorable to U.S. creditors and debtors would not be applied. Again, however, this strict rule does not consider the section 304 factors to determine which law should be applied.<sup>147</sup> Also, U.S. bankruptcy courts have not been eager to employ tax law principles.<sup>148</sup>

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146. JACOB MERTENS, JR., *MERTENS LAW OF FEDERAL INCOME TAXATION* § 45E.147 (1994) ("Valuation of Assets and Liabilities—Any accounting practice systematically undervaluing assets or overvaluing liabilities is prohibited; even though allowed or required under foreign law, except where allowed under United States tax accounting standards . . .").

147. See *supra* Part III.B.

148. *In re Lewiston Steam & Power Assocs.*, No. B86-00477-Y, 1989 Bankr. LEXIS 1382, at \*6-7 (Bankr. N.D. Ohio 1989) (holding that tax cases are considered inappropriate since recharacterization of loans as capital contributions is outside the court's equitable powers); *In re Pacific Express, Inc.*, 69 B.R. 112, 115 (9th Cir. 1986).



### 1. U.K. Law in U.S. Bankruptcy Courts

By honoring U.K. law, U.S. bankruptcy courts may find that the guaranty amount may not be listed on Engen's balance sheet. Without the guaranty on the balance sheet to show that Engen was insolvent, it would be difficult for the trustee to avoid the transfer under the "balance sheet test."

The bankruptcy court could still consider, however, whether Engen is paying its debts as they come due. Thus, even if Engen is solvent under the "balance sheet test," it may still be considered insolvent for the purpose of finding a fraudulent transfer.

### 2. Canadian Law in U.S. Bankruptcy Courts

If Cangen is placed in involuntary bankruptcy proceedings in Canada at the same time that Cangen files for bankruptcy in the United States, a foreign representative of the Canadian bankruptcy may use an ancillary proceeding to request that the U.S. bankruptcy court apply Canadian law. If the U.S. bankruptcy court follows the Canadian BIA, Cangen may show insolvency at the time of the transfer, which it could not show under U.S. laws.

As previously noted, if U.S. bankruptcy courts apply the Canadian Act, no recovery would be allowed.

## VI. CONCLUSION

By filing for bankruptcy in the United States, it appears that Engen or Cangen can take advantage of the U.S. bankruptcy court's calculation of liabilities because U.S. bankruptcy calculations differ from Engen's and Cangen's native court's calculations, as well as U.S. bankruptcy law's shorter time limitations to void transfers as fraudulent.<sup>149</sup> Assuming foreign creditors will have equal standing in the bankruptcy court, allowing Cangen and Engen to avoid transfers may be inconsistent with a foreign country's bankruptcy policy. As previously noted, some foreign countries favor equitable treatment of creditors, and their policies are designed to protect and favor creditors unlike the U.S. policy of giving debtor's a fresh start.<sup>150</sup>

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149. McQuiston, *supra* note 2, at 140-72 (providing guidelines for writing an enforceable guaranty).

150. For a discussion of bankruptcy policies, see *supra* Part III.A.

The results under U.K. or Canadian bankruptcy law, however, are not immutable. Due to the various ways debtors are found insolvent, courts applying U.K. and Canadian law have different results, depending on which test the court applies. Because the varied results do not appear to reflect a "hard" policy of the legislature, applying U.S. law does not transgress either U.K. or Canadian policies. Thus, if U.S. bankruptcy courts apply U.S. bankruptcy law, Engen and Cangen could take advantage of U.S. bankruptcy rules.

If U.S. courts apply U.S. bankruptcy rules, lenders can protect themselves from fraudulent transfer liability by obtaining evidence of the solvency of the primary obligor: the lower the risk, the less likely the call on the guaranty, the less likely the call, the less the guaranty will affect the guarantor's balance sheet. The "risk of call" calculation could be prepared by an independent accountant. This calculation is preferable to later calculations because it is not influenced by hindsight. Thus, Genbank could specify the possibility that Engen and Cangen will be required to pay Pargen's debt. Although this is not binding on the bankruptcy court, it is a strong indication of what the actual risks were at the time of the transaction.

If corporations are concerned about their rights in a subsequent bankruptcy, the contracting parties can draft a choice of law clause.<sup>151</sup> Thus, Genbank may specify which country's law a court should apply in the event Engen or Cangen files for bankruptcy.

Genbank may also protect itself by obtaining a security interest in Pargen's assets at the time the guaranty is obtained. A security interest would give Genbank priority over other creditors if the interest is perfected.

Ancillary proceedings have additional considerations. On one hand, if a U.S. bankruptcy court applies foreign bankruptcy law in an ancillary proceeding, the court may contravene U.S. bankruptcy policy. On the other hand, it may seem "fair" to foreign creditors to follow foreign bankruptcy law because the creditors, arguably,

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151. See *Jackson v. Culinary School of Washington*, 788 F. Supp. 1233, 1263 (Bankr. D.C. 1992) (stating "[t]he Rules of Civil Procedure do not prevent the Court from considering the existence of this jurisdictional clause . . ."); *In re St. Johnsbury Trucking Co., Inc.*, 174 B.R. 186, 188 (Bankr. D.Vt. 1994) (using federal choice of law principles to determine which state law applies to a fraudulent transfer).

have relied on and assumed that the foreign country's law would apply. The application of foreign law, however, may be unfair to U.S. creditors.

The quandary in applying a foreign country's laws is that there is no horizontal equity. Similarly situated creditors are treated differently. Although the U.K. and Canadian creditors of Engen and Cangen are situated similarly to U.S. creditors, the creditors located in the United Kingdom or Canada are treated differently from U.S. creditors because different laws apply to the different entities.<sup>152</sup>

In ancillary proceedings, the court will either recognize foreign law or dismiss the ancillary proceeding, thus applying U.S. law by default.<sup>153</sup> U.S. bankruptcy rules will likely be used in ancillary proceedings for several reasons. First, bankruptcy courts will tend to be protective of domestic concerns.<sup>154</sup> Second, bankruptcy courts will seek to prevent fraudulent transfers.<sup>155</sup> Third, U.S. bankruptcy courts better understand of domestic laws and are familiar with avoiding fraudulent transfers as defined by U.S. standards.<sup>156</sup>

Another consideration when applying U.S. law in ancillary proceedings is the equitable treatment of creditors. If U.S. laws automatically apply to all bankruptcies filed in the United States, once Engen and Cangen file for bankruptcy in the United States, Engen's and Cangen's creditors will know U.S. law applies and that the law applies to each creditor equally. By applying U.S. laws, the U.S. bankruptcy court and Engen's and Cangen's creditors save time and money. It is not necessary for the parties to litigate the choice of law issue.

Thus, for the reasons stated above, foreign creditors are treated fairly if U.S. bankruptcy courts apply U.S. bankruptcy rules in a foreign debtor's U.S. bankruptcy. If all parties are aware that U.S. bankruptcy law applies if the debtor subsequently files for bankruptcy in the United States, the creditor may protect itself in advance.

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152. See *supra* Part III.

153. Westbrook, *supra* note 11, at 37.

154. DALHUISEN, *supra* note 13, at 3-405.

155. *Id.* at 3-411.

156. *Id.* at 3-420.

By allowing less than the full amount of the guaranty on the balance sheet, U.S. bankruptcy courts promote the policy of honoring the debtor's preferences. One problem with listing less than the full amount of the guaranty on the balance sheet is determining what value is appropriate. U.S. bankruptcy courts are also attempting to come to terms with ascertaining the proper statistic. Currently, U.S. bankruptcy courts do not allow insiders of the debtor to have input into the calculations of the probabilities after the fact. One solution could be to allow financial experts to determine the likelihood that the guarantor would be required to pay the amount guaranteed. A calculation done by a third party would eliminate some of the current subjectivity from the calculation. Also, as mentioned, the parties may calculate the probabilities objectively at the time the guaranty is given and include that calculation in the contract. This calculation has greater objectivity and is not influenced by hindsight and, therefore, may have more weight with the court.

Applying U.S. bankruptcy law in all U.S. bankruptcy cases, including ancillary proceedings, and integrating an objective calculation of the probability that the debtor will be required to pay the guaranty calculated at the time the guaranty is given is practical and fair to all parties.

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